

Br2: PBray

FEB 28 1990

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Availability of section 883 exemption

This memorandum responds to questions from Bill Pfeil to Christine Halphen and to a memorandum from Hildy Riegelhaupt dated November 29, 1989, regarding the application of reciprocal exemptions for shipping income under certain treaties, or under section 883. We are providing a combined response to both inquires. Questions 1 and 3 below discuss general provisions of the law applicable to post-1986 years, while questions 2 and 4 apply the law to specific fact patterns involving both pre-1986 and post-1986 law.

QUESTION 1: Equivalent Exemptions.

Is the Barbados Treaty considered an equivalent exemption?

Generally, under section 883, shipping income is excluded from gross income where an equivalent exemption is provided by a foreign country to U.S. persons based on an exchange of diplomatic notes or the domestic law of that foreign country. Therefore, a foreign country which provides an exemption which satisfies the conditions of sections 883(a) or 872(b) by either of these methods would be considered to grant an "equivalent exemption".

Where a foreign corporation is organized in a country which has entered into a treaty with the United States providing an exemption for shipping or aircraft income, and where the corporation is eligible for benefits under the terms of the treaty, the exemption would be provided under the treaty and section 894, rather than under section 883(a) of the Code.^{1/}

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1/ If the foreign corporation does not qualify for the treaty exemption (because it does not satisfy the limitations on benefits provisions or for other reasons), then an exception may be available under section 883. Whether the

Code	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer
Surname	<p>treaty country grants an equivalent exemption outside the treaty must be researched. The mere fact that a treaty exists does not automatically establish the existence of an equivalent exemption.</p>						

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There is one circumstance in which a treaty exemption is treated as an equivalent exemption under section 883. The general rule of section 883(c)(1) provides that the section 883(a) exemption will not apply to a foreign corporation if 50% or more of the value of the stock of the corporation is owned by individuals who are not residents of the foreign country in which the corporation is organized, or of another foreign country granting an equivalent exemption to U.S. corporations. Section 883(c)(4) provides that for purposes of paragraph (c)(1), stock owned (directly or indirectly) by or for a corporation is treated as being owned proportionately by its shareholders. Thus, a corporation organized in a non-treaty country, which provides an equivalent exemption under either a diplomatic note or its domestic law, would qualify for the exemption under section 883(a) only if more than 50 percent of the ultimate individual shareholders are resident in that country, or are residents in other countries that grant an equivalent exemption.

A country that has a treaty with the United States which exempts income from the international operation of ships or aircraft would be considered as granting an equivalent exemption for purposes of making the section 883(c) determination of whether the shareholders are resident in a country which grants a equivalent exemption. The test is whether the shareholder would be eligible for benefits under the treaty if he were the operator of the vessel or aircraft. Thus, conditions under the treaty must be met, such as registration of the aircraft or documentation of the ship.

For example, in order for income from the operation of the vessel to be eligible for benefits under the U.S.-Denmark treaty, the vessel must be documented in Denmark. Therefore, if a corporation organized in Liberia and seeking benefits under section 883(a) operated a vessel that was documented in Denmark, the value of the shares of a shareholder resident in Denmark could be counted in determining whether the more than 50% of value test of section 883(c) is satisfied. See Notice 88-5, 1988-1 C.B. 476. For purposes of the section 883(c) test the vessel would be deemed operated by the shareholder in applying the terms of the Danish treaty. If the vessel was documented in another country, the terms of the Danish treaty would not be satisfied and the value of the shares of the Liberian corporation belonging to the shareholder resident in Denmark could not be counted under section 883(c), even though Denmark has a treaty with the United States which is considered to grant an equivalent exemption for shipping income.

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QUESTION 2: Shipping Exemptions Available In Barbados.

For purposes of demonstrating the exemptions from United States taxation for shipping income under section 883 of the Code and under the income tax convention between Barbados and the United States, you asked us to consider the example of a Barbados corporation for taxable years 1985, 1986, and 1987. X is a corporation organized in Bermuda whose stock is publicly traded on a stock exchange in the United Kingdom. X owns 51% of Y, a corporation organized in Liberia. An unrelated non-U.S. person owns 49% of Y. Y owns 100% of Z, a corporation organized in Barbados. Z owns a ship that is documented in Panama and that carries passengers in and out of U.S. ports. Z is engaged in a U.S. trade or business as a result of its cruise line activities, and would be taxable on its effectively connected income from those activities under section 882 absent any treaty or statutory exemption which may apply.

Years 1985-1986

For taxable years 1985 and 1986, section 883(a) provided an exemption for earnings derived from the operation of a ship, provided the ship was documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States. Generally, such an exemption would be provided under section 883 by either a diplomatic note or the domestic law of a foreign country. In addition to section 883, an exemption could also be available under an income tax convention between the United States and the country of residence, or of documentation of the vessel.

During 1985 and 1986, there was a diplomatic note in effect between the United States and Panama. This note provided an exemption from U.S. and Panamanian tax for revenues derived from the operation in maritime commerce of merchant ships. Because the vessel owned by Z is documented in Panama, the shipping income of Z was excludable from gross income under section 883 for its 1985 and 1986 taxable years.

In addition to the exemption available under section 883 of the Code through the diplomatic note with Panama, an exemption might also be possible through a treaty between the United States and Barbados. On December 31, 1984, representatives of the United States and Barbados signed an income tax convention (the "Treaty"). Instruments of ratification were exchanged on February 28, 1986. The Treaty came into force on that day and generally is effective as of January 1, 1984. It would not be necessary for Z to seek exemption under the Treaty because the diplomatic note between the United States and Panama applies for years prior to 1987. See page 6 for an explanation of how the

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Treaty would apply to these facts as an alternative to the statutory benefits under section 883.

Year 1987 - Exemption under section 883

For taxable years beginning after December 31, 1986, section 883(a) of the Code provides that gross income derived by a corporation organized in a foreign country from the international operation of ships shall not be included in gross income if such foreign country grants an equivalent exemption to corporations organized in the United States. This post-'86 exemption is not based on place of documentation, but rather on place of organization of the corporation operating or leasing the vessel.

For a corporation organized in Barbados to qualify for benefits under section 883, there must be in effect either an exchange of diplomatic notes between Barbados and the United States, or a qualifying domestic statute during the taxable years in issue. There is no diplomatic note in effect with Barbados which exempts shipping income for taxable years beginning after December 31, 1986. We have examined the domestic law of Barbados (section 18 of the Income Tax Act, Part 2) and determined that the relevant statute does provide for an equivalent exemption for purposes of section 883 for taxable years after 1986. Sec. 18 provides:

18. BUSINESS OF OPERATING SHIPS OR AIRCRAFT.

In calculating the assessable income for a non-resident person for an income year, the income of that person earned in Barbados from the operation of a ship or aircraft owned, chartered or operated by him shall-
(a) not be included, where the country or territory where that person resides grants substantially similar relief throughout the income year to a person resident in Barbados;

The Commissioner of Inland Revenue of Barbados represented in writing that this exemption covers both individuals and corporations for operating income, full and bareboat charter income, income from the rental of containers if incidental to operating income, and gains from the sale of a vessel or aircraft if incidental to operating income.^{2/}

^{2/} You provided a copy of materials on the Barbados Shipping (Incentives) Act, 1982 (CAP.90A). It appears that concessions are available to approved shipping companies engaged in specific shipping activities, including a 10 year tax exemption as well as freedom from customs duty on all materials connected with the company's shipping activities. This statute does not qualify under section 883 because it does not exempt

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Because the domestic law of Barbados contains an exemption which qualifies under section 883 for tax years beginning after December 31, 1986, Z will be eligible for benefits under section 883 if it also satisfies the requirements of section 883(c).

The general rule of section 883(c)(1) provides that the section 883(a) exemption will not apply if 50% or more of the value of the stock of the corporation is owned by individuals who are not residents of such foreign country or of another foreign country which grants an equivalent exemption to U.S. corporations.

Section 883(c)(4) provides that for purposes of the general rules of paragraph (c)(1), stock owned (directly or indirectly) by or for a corporation is treated as being owned proportionately by its shareholders. Z is 100% owned by Y. Y is owned 51% by X, a corporation organized in Bermuda and publicly traded on a United Kingdom stock exchange. Section 883(c)(3) provides that the 50 percent ownership requirement of paragraph (c)(1) shall not apply to any corporation which is organized in a foreign country granting an equivalent exemption if its stock is primarily and regularly traded on an established securities market in such foreign country, another foreign country meeting the requirements of such paragraph or the United States. If the publicly traded corporation owns stock (directly or indirectly) in another corporation, the other corporation is treated as owned by individuals who are residents of the foreign country in which the publicly traded corporation is organized.

The facts supplied do not indicate whether the stock of X was "primarily and regularly traded" on an "established securities market" in the U.K. If it is so traded, 51 percent of the stock of Z is deemed owned by individuals resident in Bermuda. Z would meet the requirements of section 883(c) because X is publicly traded in the U.K., and because both the U.K. (through a treaty) and Bermuda (through an exchange of notes) are equivalent exemption jurisdictions. Therefore, the shareholders of X are treated as residents of Bermuda. Because X indirectly owns 51% of the stock of Z, the value of those shares is considered owned by the ultimate individual shareholders of Z who are considered to be residents of Bermuda. Consequently, Z would satisfy the requirements of section 883(c).

U.S. corporations not resident in Barbados. It is designed primarily to encourage foreign persons to invest in business in Barbados. The statute only benefits corporations resident in Barbados.

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If the stock of X is not so traded, the conditions of section 883(c) may not be satisfied. Z would have to provide documentation to show that more than 50 percent of the beneficial interests in the Liberian corporation, Y, were ultimately owned by individuals who were residents of qualifying countries.

Year 1987 - Exemption under the Treaty

Z might also seek exemption from U.S. tax under the Treaty. Article 8 of the Treaty provides, in substance and in part, that the profits of an enterprise of Barbados from the operation of ships in international traffic is taxable only in Barbados. The benefits of Article 8 are conditioned upon satisfying the limitation on benefits provisions of Article 22.

Article 22 is intended to prevent a Barbados company owned by shareholders not residing in Barbados or the United States from using the Treaty to secure certain tax benefits. However, a Barbados corporation that fails the ownership requirements may still claim benefits under the treaty if the income derived from the United States is derived in connection with, or is incidental to, the active conduct of a trade or business in Barbados (other than the business of making or managing investments).^{3/}

Paragraph 3 of Article 22 provides that the look-through provision will not apply where the Barbados company's principal class of shares is substantially and regularly traded on a recognized stock exchange. The term "recognized stock exchange" means the NASDAQ System, any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, and

^{3/} The Joint Committee on Taxation's explanation of paragraph 2 of Article 22 of the treaty, and the Senate Foreign Relations Committee's report discussing paragraph 2 of Article 22 both provide that "[t]wo general exceptions apply to rules denying benefits. First, treaty benefits are preserved if the resident entity's income is derived in connection with, or is incidental to, the active conduct of a trade or business in the source country" (emphasis added). Thus, under this interpretation, if Z is engaged in the active conduct of a trade or business in the United States (the source country) through its cruise operations, Z's treaty benefits would be preserved. This rather curious explanation is at odds with the language in the treaty and in the Technical Explanation prepared by the Treasury Department, which negotiated the treaty. The proper interpretation is that the source state will not deny benefits under Article 22 if income in respect of which benefits are claimed is derived in connection with, or is incidental to, the active conduct of a shipping business in the residence state.

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any other stock exchange agreed upon by the competent authority of the Contracting States.

Z is organized in Barbados, is 100 percent owned by a Liberian corporation, and therefore privately held. Z is actively engaged in a trade or business (operating a cruise line) in the United States. It is assumed that Z does not meet the ownership requirements of Article 22 because 50 percent or less of the beneficial interest of Z is owned, directly or indirectly, by any combination of individual residents of the United States or of Barbados, or by U.S. citizens. Thus, the general denial of benefits rule of paragraph 1 of Article 22 applies.

Assuming that Z is not also actively engaged in a trade or business in Barbados, it falls outside the first exception to the general denial of benefits rule found in paragraph 2 of Article 22. Because Z is not publicly traded on a recognized stock exchange, it falls outside the second exception to the general denial of benefits rule found in paragraph 3 of Article 22. Consequently, Z would not be eligible for benefits under Article 8 of the Treaty.

If, in addition to its activities in the United States, Z is also actively engaged in a trade or business in Barbados, the first exception in paragraph 2 of Article 22 would apply, and paragraph 1 of Article 22, the limitation on benefits article, would not deny benefits otherwise available to Z under Article 8. Whether Z is actively engaged in a trade or business in Barbados is a question of fact to be determined under Barbados law.

Where the terms of Article 8 are satisfied and where Article 22 does not operate to prevent a Barbados corporation from receiving the benefits of Article 8, an exemption would be granted under the Treaty and section 894 instead of under section 883.

Conclusion

Based on the facts provided, and assuming that Z is not engaged in the active conduct of a trade or business in Barbados, Z is not eligible for benefits under the U.S.-Barbados treaty for any year in issue. Barbados does not provide an equivalent exemption by any other method for taxable years 1985 or 1986. However, Panama, the country of documentation of the vessel, does provide an equivalent exemption for this period.

The domestic law of Barbados grants an equivalent exemption to corporations organized in the United States for 1987 and subsequent years. Provided that the assumption made above

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regarding the publicly traded exception continues to apply, Z satisfies both the section 883(a) test, based on this domestic law, and the section 883(c) test for 1987 and subsequent years. Therefore, the income of Z earned from the operation of ships would be excluded from gross income for 1985, 1986, and 1987.

QUESTION 3: Managed and Controlled.

A basic question concerning the Treaty is whether a company which merely holds its annual meetings in Barbados can be considered to be "managed and controlled" there. This question is relevant to determine when a corporation is treated as a resident of Barbados under Article 4 of the Treaty. It is also relevant for determining when a corporation is a resident of Barbados under its domestic law for purposes of section 883(a) for 1987 and subsequent years.

The Treasury Department Technical Explanation of the Treaty maintains that in the case of a term not defined in the Treaty the domestic law of the contracting State applying to the Treaty shall control, unless the context in which the term is used requires a definition independent of domestic tax law or the competent authorities agree on a different meaning.

While the Joint Committee on Taxation's explanation of Article 4, Residence, comments that the definition of a term that is not otherwise defined in the treaty is generally based on the definitions in the U.S. and OECD model treaties, the definition for purposes of an individual treaty must reflect the domestic law of the country which is applying the treaty. The term "managed and controlled" is not defined in the U.S.-Barbados treaty discussion of "resident" under Article 4. It is useful to examine the explanation of these terms under the OECD model treaty to gain a general understanding of their interpretation.

The commentary on Article 4 of the OECD model treaty concerning the definition of resident is clear:

Paragraph 3

....

22. It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed.

23. The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance

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of double taxation on such income accord the taxing power to the state in which the "place of management" of the enterprise is situated; other conventions attach importance to its "place of effective management", others again to the "fiscal domicile of the operator". Concerning conventions concluded by the United Kingdom which provide that a company shall be regarded as resident in the state in which "its business is managed and controlled", it has been made clear on the United Kingdom side, that this expression means the "effective management" of the enterprise.

24. As a result of these conditions, the "place of effective management" has been adopted as the preference criterion for persons other than individuals.

For purposes of determining whether a corporation is a resident of Barbados under the Treaty, Barbados tax authorities have stated to us that a corporation is "managed and controlled" where "central management and control abides". Whether merely holding annual meetings in Barbados means that Barbados is the place of central management and control of the corporation must be determined under Barbados law, which we have not researched. A taxpayer under examination must provide documentation from the government of Barbados or other support for its claim that it is a resident of Barbados in order to receive treaty benefits. We have enclosed a memorandum from an unrelated case that may be useful in determining the meaning of "managed and controlled" under Barbados law.

If it is determined that Z is not a resident of Barbados for treaty purposes, then its exemption from U.S. tax could only be based on section 883(a) based on the domestic law of Barbados. See the discussion under Question 2 above for applying section 883(a).

QUESTION 4: Liberian Corporation operating in Barbados.

M is a corporation organized in Bermuda whose stock is publicly traded on a stock exchange in the United Kingdom. M owns 51% of N, a corporation organized in Liberia. An unrelated non-U.S. person owns 49% of N. N owns 100% of O, a corporation organized in Liberia and engaged in the shipping business. O owns a ship that is documented in Panama and that carries passengers in and out of U.S. ports. O is engaged in a trade or business in the United States by virtue of its cruise line activities, and would be taxable on its effectively connected income from those activities under section 882 absent any treaty or statutory exemption which may be available.

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O included a statement on its 1987 U.S. income tax return that it is a foreign corporation resident in Barbados. If O was "managed and controlled" in Barbados, O would be treated as a resident of Barbados for purposes of the treaty and would seem to be eligible for benefits under Article 8, provided that Article 22 did not prevent qualification for those benefits. However, because it is 100% owned by a Liberian corporation, N, Article 22 would operate to prevent O from receiving benefits under the treaty, provided the exceptions under paragraphs 2 and 3 of Article 22 do not apply. (The materials upon which these facts are based are not sufficient to enable us to determine whether an exception to those treaty shopping rules apply.) Because Article 22, paragraph 1 applies, and if the exceptions in paragraphs 2 and 3 of Article 22 do not apply, O is not eligible for benefits under the U.S.-Barbados treaty for 1985, 1986, or 1987. You should determine whether O is engaged in an active trade or business in Barbados.

Because its vessel was registered in Panama during 1985 and 1986, O would satisfy the requirements of section 883 for 1985 and 1986, as there was a diplomatic note in effect between the U.S. and Panama covering shipping income during that period. In 1987 and subsequent years, because O is not organized in Panama, it cannot satisfy the section 883(a) test under the diplomatic note with Panama.

For 1987 and subsequent years, Barbados had no diplomatic note which satisfied the requirements of section 883. However, Barbados did have a domestic law which provides an equivalent exemption for this period. Since O was not organized in Barbados, even though it may be a resident of Barbados, i.e., managed and controlled in Barbados, it cannot satisfy the requirements of section 883 under the Barbados domestic law.

However, because O was organized in Liberia, it satisfies the section 883(a) test for 1987 and subsequent years, regardless of where the vessel may be registered, because Liberia has a diplomatic note covering shipping income in effect with the United States for years after 1986.

Where a corporation satisfies the section 883(a) test on the basis of a diplomatic note or of the domestic law of a foreign country, it must also satisfy the conditions in section 883(c) before it may receive benefits under this section for 1987 and subsequent years. See the discussion above at pages 5 and 6 regarding satisfaction of the section 883(c) requirements under similar facts. Provided that the shares of the Bermuda corporation are "primarily and regularly traded" on an "established securities market" in the U.K., O is entitled to

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section 883(a) benefits for 1987 and subsequent years because it is organized in Liberia (subject to continued satisfaction of requirements under section 883(c)). If the shares of the Bermuda corporation are not so traded, O would have to provide documentation to prove that more than 50% of the value of N's share of O stock is ultimately owned by residents of countries which provide an equivalent exemption for shipping income. Such a determination would be based on the principles of Notice 88-5 discussed at page 2 above.

If O does not qualify for an exemption under section 883(a) because it fails to qualify under the ownership rules of section 883(c), then it is unlikely that its shipping income can be exempt from U.S. tax for years after 1986, because it probably also could not qualify for benefits under the Treaty. However, it could qualify for benefits under the treaty if O is engaged in an active trade or business in Barbados.

We apologize for any inconvenience that the delay in responding to your questions may have caused and we hope that this information is helpful to you and other agents with shipping-related issues.

Enclosures